Supreme Court, U. S.
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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1974

No. 74-443

LIBERTY LOAN CORPORATION, a Corporation,
Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

PETITION FOR A WRIT OF CERTIORARI

To the United States Court of Appeals for the Eighth Circuit

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The taxpayer-petitioner, Liberty Loan Corporation ("Liberty"), hereby petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Eighth Circuit in this case.

OPINIONS BELOW

The opinion of the district court (Appendix A, *infra*, pp. A1 to A14, inclusive) in favor of the taxpayer is reported at 359 F. Supp. 158. The opinion of the court of appeals (Appendix B, *infra*, pp. A15 to A30, inclusive) reversing the district court is reported at 498 F. 2d 225.

JURISDICTION

The opinion and judgment of the court of appeals were entered on May 31, 1974. Taxpayer's petition for rehearing was timely filed on July 8, 1974 (pursuant to timely extensions of time to that date) and was denied on July 19, 1974 (Appendix C, *infra*, p. A31). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Does the Commissioner of Internal Revenue have the absolute discretion under Section 482 of the Internal Revenue Code to reallocate income among the individual corporate members of a corporate group, without regard to the actual effect of the underlying transaction on the income of each of those entities?

2. Did the Court of Appeals ignore fundamental principles of tax law and disregard the rule of *Eisner v. Macomber*, 252 U.S. 189 (1920) by holding that an increase in a taxpayer's net worth constitutes an increase in its net income?

STATUTES AND REGULATIONS INVOLVED

Section 482 of the Internal Revenue Code of 1954, in its entirety, and the pertinent portions of Treasury Regulations on Income Tax (§§ 1.482-1(a)(6), (b)(1), (d)(1) and 1.482-2 (a)(1) and (2)) are set forth in Appendix D, *infra*, pp. A32 to A35, inclusive.

STATEMENT OF THE CASE

This case was submitted to the district court on a stipulation of facts and appended exhibits, briefs and oral argument. The facts as found by the district court were as follows:

Liberty is engaged in the consumer finance business. In the year at suit, 1961, it operated through 40 branch offices and 399 subsidiaries (each having one or more offices) in making installment loans directly to borrowers and purchasing (usually at a discount) installment notes receivable issued to dealers by purchasers of goods and services. (Appendix A, *infra*, pp. A2-A3).

It is the practice of finance companies to borrow funds; where there is an affiliated group and large sums are required, the borrowing is usually done by the parent on behalf of the group. For 1961, Liberty so borrowed $110,547,621 (computed on the basis of a monthly average) and incurred interest expense in the amount of $5,582,751, an effective interest rate of 5.55 percent. Liberty was fully reimbursed, as follows: interest was charged all branches[1] and all solvent subsidiaries at the rate of 5.75 percent; subsidiaries whose capital Liberty regarded as impaired were charged no interest. Determination of whether a subsidiary's capital was impaired was made twice a year. In 1961 this resulted in 28 of the subsidiaries paying interest at the rate of 5.75 percent for half a year only and 27 paying no interest at all for the entire year. (Appendix A, *infra*, pp. A3-A7).

On audit, the Commissioner of Internal Revenue ("Commissioner") allocated interest to Liberty from the 54 subsidiaries at the rate of 5 percent, less the interest paid to Liberty by those subsidiaries ($198,542), or in the amount of $473,639. Liberty paid the resulting tax and interest, and on disallowance of its claim for refund, initiated this action by suit in the district court. The Commissioner did not challenge the treatment of the transaction by any of the subsidiaries and they are not parties to this litigation.

The trial court found that Liberty was fully reimbursed for all but its own share of the borrowing costs it incurred on be-

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[1] This was an internal control procedure and resulted in no separate tax consequence. (Appendix A, *infra*, p. A7).

half of the group, that its 1961 return clearly reflected its income and that there had been no evasion of tax on its part. The trial court found that while the burden of reimbursing Liberty for the interest expense it incurred on behalf of the group was shifted away from the members of the group whose capital was impaired to those whose capital was not impaired in accordance with a pre-established formula, this did not distort *Liberty's* income. The trial court further found that the Commissioner, in isolating the non-paying subsidiaries from the remainder of the group, had ignored the substance of the group relationship and therefore had not attempted to correct the distortion in incomes created among them, presumably in order "to produce a higher harvest of revenue." The trial court therefore concluded that the Commissioner's allocation of interest income from the impaired subsidiaries to Liberty distorted the latter's income and was accordingly unreasonable, arbitrary and capricious. (Appendix A, *infra*, pp. A7-9, 10, 12-13).

In reaching its conclusions, the trial court was guided by Reg. § 1.482-1(d)(1) (Appendix D, *infra*, pp. A33-34), requiring the *substance* of the transactions in question to be analyzed to determine the appropriate allocation, and Reg. § 1.482-1(b)(1) (Appendix D, *infra*, pp. A33), mandating the Commissioner to allocate *"between or among the controlled taxpayers constituting the group"* so as to determine "the true taxable income of *each* controlled taxpayer." (Appendix A, *infra*, pp. A12-13).

The court of appeals reversed in a split decision. The dissenting judge, Senior Judge Van Oosterhout, would have affirmed on the basis that the essential findings (quoted, see p. A28, *infra*) of the trial court were supported by substantial evidence and were not induced by any erroneous view of the law. (Appendix B, *infra*, pp. A15-30).

REASONS FOR GRANTING THE WRIT

The majority below reversed the trial court on two grounds: (i) it found ". . . that the 'group loan' theory of the trial court ignores the actual substance of the transactions under scrutiny . . ." (Appendix B, *infra*, p. A19) and, that viewed independently, the "no-interest" loans to the insolvent subsidiaries distorted Liberty's 1961 taxable income (Appendix B, *infra*, p. A20), and (ii) it found a distortion in Liberty's 1961 taxable income in any event (i.e., even if the "group loan" premise were accepted) because the savings in taxes realized by its subsidiaries had the effect of increasing Liberty's net worth (Appendix B, *infra*, p. A21).

With respect to (i), above, the majority below exceeded the scope of review permitted by Rule 52(a), FRCP and erred as to the scope of § 482. With respect to (ii), above it is in conflict with a landmark decision of this Court, *Eisner v. Macomber*, 252 U.S. 189 (1920). Loan arrangements typified by the instant case are common to the finance business, and to businesses in general operating in a corporate group. Resolution of the question posed by this case is therefore highly important to the orderly administration of the tax laws.

1. Although Section 482 has been in the federal income tax statutes since 1928[2] and has been increasingly used by the Commissioner, it has been considered on its merits by this Court only once.[3] It has been labelled an "amalgam" of several important themes and policies of tax law whose regulations fail to distinguish between the various facets and functions of the

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[2] It first appeared as Section 45 of the Revenue Act of 1928 (c.852, 45 Stat 791, 806).

[3] *Commissioner v. First Security Bank of Utah, N.A.*, 405 U.S. 394 (1972).

section[4] That comment is particularly apropos here. Given the propensity the Internal Revenue Service has exhibited to date to explore in an aggressive manner its outer boundaries, it is likely that the number of petitions for certiorari filed by taxpayers involving Section 482 will continue to grow unabated. This case presents a highly suitable vehicle for this Court to resolve several of the uncertainties concerning its scope.

The Internal Revenue Service's RIRA system[5] indicated as of a recent date that there were 45 groups of taxpayers involving 83 separate docketed cases in the courts concerning proposed intercompany interest allocations pursuant to Section 482. There are, of course, many more cases pending in the courts involving other facets of Section 482.[6] Many of these involve a "prime" issue,[7] and hence will likely result in extended litigation. While the amounts in dispute in these cases, and in the many cases which must still be in the administrative process, are not readily available to the petitioner, such amount must be very substantial indeed. In any event, it is clear that the volume of litigation in this area has created a further need for this Court to act.

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[4] B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders (3rd ed. 1971) 15-21, 15-28.

[5] The Reports and Information Retrieval Activity program ("RIRA") is described in K. Martin Worthy, The Chief Counsel's Office in the Seventies, 48 Taxes 5 (1970) at pp. 10-11.

[6] Jenks, Treasury Regulations Under Section 482, 23 Tax Lawyer 279 (1970) at pp. 280-1. See also pp. 288 and 294 (inclg fn 55) concerning retroactivity. The docketed cases involving § 482 in its various facets number in the hundreds.

[7] The Internal Revenue Service first published its list of "prime" issues in March, 1973. They are issues which the Service will ordinarily insist on litigating and that ordinarily will not be conceded or compromised. This subject is discussed further in the article referred to in fn 6, above. (Liberty is shown on the RIRA list, fn 6, supra, as a "prime" issue case).

Although the Eighth Circuit appears to be the first appellate court to rule on this question, so that there is no present conflict of circuits, it is not feasible in the light of the potential importance of the question to await the development of such a conflict.

2. The majority below dismissed the trial court's "group loan" findings even though, as pointed out in the dissent, those findings were supported by substantial evidence and were not induced by any erroneous view of the law. (Appendix B, *infra*, p. A29). Realizing the impact of the extremeness of its retrial of the facts, the majority below sought to support its result by reversing the trial court as a matter of law. This it did in the following manner (Appendix B, *infra*, p. A20-A21):

> We note also that even if one were to accept the "group loan" premise of the trial court, there is nevertheless a distortion in taxpayer's income. As the trial court recognized:
>
> > Low or no income subsidiaries would have significantly less use for an interest expense deduction, whereas a subsidiary corporation in a surtax bracket would be able to utilize the deduction against higher tax rates. *The internal apportionment undoubtedly led to substantial overall savings in taxes to the group, taken as a whole.* (Emphasis added.)
>
> 359 F.Supp. at 162-163.
>
> We think it obvious that any savings in taxes realized by the subsidiaries has the effect of increasing the parent's net worth and hence distorting its true income. And as one commentator has observed, "[t]he purpose of the section is to prevent corporations within the same corporate family from utilizing their separate corporate structures to diminish the overall tax liability of the corporate family." Note, 6 N.Y.U.J.Int.L. & Politics 169, 171

(1973). Thus, any distortion in the income of the subsidiaries is necessarily a distortion of the parent's income as well.

Whether the majority below intended its holding to mean generally, or just for purposes of Section 482, that an increase in net worth represents an increase in taxable income, its decision violates the teachings of *Eisner v. Macomber, supra.*

In passing on whether a stock dividend was taxable under the Sixteenth Amendment, this Court stated in that case:

> After examining dictionaries in common use (Bouv. L. D.; Standard Dict.; Webster's Internat. Dict.; Century Dict.), we find little to add to the succinct definition adopted in two cases arising under the Corporation Tax Act of 1909 (*Stratton's Independence v. Howbert*, 231 U. S. 399, 415; *Doyle v. Mitchell Bros. Co.*, 247 U. S. 179, 185)—"Income may be defined as the gain derived from capital, from labor, or from both combined," provided it be understood to include profit gained through a sale or conversion of capital assets, to which it was applied in the *Doyle Case* (pp. 183, 185).
>
> Brief as it is, it indicates the characteristic and distinguishing attribute of income essential for a correct solution of the present controversy. The Government, although basing its argument upon the definition as quoted, placed chief emphasis upon the word "gain," which was extended to include a variety of meanings; while the significance of the next three words was either overlooked or misconceived. "*Derived—from—capital*";—"the *gain—derived—from—capital*," etc. Here we have the essential matter: *not* a gain *accruing* to capital, not a *growth* or *increment* of value *in* the investment; but a gain, a profit, something of exchangeable value *proceeding from* the property, *severed from* the capital however invested or employed, and *com-*

> *ing in*, being "*derived*," that is, *received* or *drawn* by the recipient (the taxpayer) for his *separate* use, benefit and disposal;—*that* is income derived from property. Nothing else answers the description. (252 U.S. at 207).

While that definition of income has been enlarged somewhat since, we know of no decision of this Court which has gone so far as to find taxable income from mere accretions in value.[*] The holding of the majority below would presumably be applicable to *all* types of Section 482 adjustments, hence its mischief is not limited to interest cases, nor just to the Eighth Circuit.

Because *Eisner v. Macomber* is a cornerstone in the structure of the income tax law, no decision that impairs its integrity should be permitted to stand. The decision below does precisely this, and, for this reason alone, should be reviewed by this Court.

3. Whether or not the findings of the trial court reversed by the majority below are reinstated in this case, there still remains a serious question of law as to whether Section 482 permits the Commissioner to make adjustments of the sort he made here, thereby substituting his own brand of distortion for that he seeks to cure. As stated by this court in the *First Security* case, Section 482 "is designed to prevent 'artificial shifting, milking, or distorting of the true net incomes of commonly controlled enterprises.' " 405 U.S. 394 at 400. The increasing of the income of Liberty for 1961 merely distorts its income. The only way in which the "shifting" or "distortion" within the group can

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[*] A leading commentator puts it even more strongly:

> We might simply note that no revenue act in the nation's history has complied with even the most elementary requirement of the Haig-Simons definition, i.e., that increases in the taxpayer's net worth (measured either annually or at the end of some other appropriate account period) be included in computing his income.

Bittker and Kaufman, Taxes and Civil Rights: "Constitutionalizing the Internal Revenue Code," 82 Yale L.J. 51, 64 (1972).

be cured is by disallowing some of the interest deductions taken by the solvent subsidiaries (the insolvent subsidiaries would be allowed the aggregate amount disallowed).

Both lower courts agreed that Liberty, as the parent of the corporate group, was fully reimbursed, (See Appendix B, *infra*, at pps. A17-18 for the appellate court's concurrence), yet the majority below in effect, held that the Commissioner could ignore this fact as a matter of law in determining against whom and in what amount reallocations were permissible. Affirmance of the majority opinion below will encourage the Internal Revenue Service to attempt reallocations as it sees fit within the corporate group, ignoring such relevant matters as the statute of limitations, the inability otherwise to reach certain foreign members of the affiliated group, whether the type of income involved causes a taxpayer to become subject to the personal holding company tax, etc. This case marks a significant departure in permitting the Commissioner to choose his own remedy unlimited by the language of Section 482 (or of some of his own regulations).[9] As one leading tax service commented, "As things now stand, IRS's Section 482 allocation authority seems unbridled."[10] Since the technique used by the Commissioner

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[9] See particularly Reg. § 1.482-1(a)(6), § 1.482-1(b)(1) and § 1.482-1(d)(1) relied upon by the trial court (Appendix A, *infra*, pp. A12-13) and set forth verbatim Appendix D, *infra*, pp. A32 to A34 inclusive.

[10] The full text of that comment is as follows:

> Comment—*Liberty Loan* looked like the strongest case yet for finding an abuse of IRS' Sec. 482 discretionary allocation authority. Contrary to the majority's point that no income was created, the case seems to be the clearest example of income creation. The Eighth Circuit had to ask: Would an unrelated corporation have lent the funds to the subsidiary group? The answer arguably would be yes. If the group loan theory is correct, and the lender would get a reasonable interest rate returned from the group as a whole, the fact some subsidiaries paid no interest and others more than their share, would be irrelevant to the lender. Of course, the lender would normally also require some guarantee from the gain companies on total

here is equally applicable to all proposed Section 482 allocations, the granting of certiorari in this case will permit this Court to remove much of the uncertainty as to the scope of that section.

CONCLUSION

This petition for a writ of certiorari should be granted.

Respectfully submitted

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principal repayment. The lower court's suggestion in *Liberty Loan* that IRS more properly should have used its Sec. 482 power to reduce the interest deductions of the gain subsidiaries rather than increasing the parent's income would have solved the problem. In effect, Liberty Loan's net worth wouldn't then be increased—a point that concerned the Eighth Circuit even if the group loan theory were accepted. And there wouldn't be any income distortion at any level. The gain subsidiaries could be viewed as contributing to the loss companies' capital to the extent they bore the loss companies' interest expense. To charge Liberty Loan with more interest income than IRS otherwise would require to clearly reflect its income may be without the intent of Congress. Also if Liberty Loan had made advances only to the gain companies at 5.75% interest, and the gain companies had contributed funds to the loss companies, presumably IRS wouldn't have stepped in. In substance that's what the lower court said happened. Hopefully Liberty Loan will seek and receive Supreme Court review. *As things now stand, IRS' Sec. 482 allocation authority seems unbridled.* Prentice Hall Federal Taxes, ¶ 60,290 (6/13/74)